

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	
AAA SIGN COMPANY	:	DETERMINATION
AND DONN COREY, AS OFFICER	:	
	:	
for Revision of a Determination or for Refund	:	
of Sales and Use Taxes under Articles 28 and 29	:	
of the Tax Law for the Period June 1, 1975	:	
through May 31, 1980.	:	

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Petitioners, AAA Sign Company and Donn Corey, as officer, c/o Boreanaz, NeMoyer & Baker, 736 Brisbane Building, Buffalo, New York 14203, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period June 1, 1975 through May 31, 1980 (File No. 800496).

A hearing was held before Timothy J. Alston, Administrative Law Judge, at the offices of the Division of Tax Appeals, 65 Court Street, Buffalo, New York, on November 18, 1987 at 1:15 P.M. Petitioners appeared by Boreanaz, NeMoyer & Baker, Esqs. (Patrick J. Baker, Esq., of counsel). The Audit Division appeared by William F. Collins, Esq. (Deborah J. Dwyer, Esq., of counsel).

ISSUES

I. Whether the Audit Division's assessment of additional tax due, determined in the absence of books and records by use of the corporate petitioner's Federal income tax returns, was proper.

II. Whether the Audit Division has met its burden of proof to show that its imposition of the fraud penalty pursuant to Tax Law § 1145(a)(2) was proper.

III. If not, whether the Audit Division may assert, at hearing, as an alternative to the fraud penalty, penalty pursuant to Tax Law § 1145(a)(1) for failure to timely file sales tax returns or timely pay sales tax.

IV. If so, whether the Audit Division has met its burden to show that imposition of the Tax Law § 1145(a)(1) penalty was proper.

V. Whether, if the fraud penalty is not properly imposed herein, certain of the periods at issue are time barred from assessment pursuant to Tax Law § 1147(b).

FINDINGS OF FACT

1. On December 7, 1981, following an audit, the Audit Division issued to petitioners herein notices of determination and demands for payment of sales and use taxes due, assessing against each petitioner \$60,975.09 in additional tax due plus interest for the period June 1, 1975 through May 31, 1980. Each of the notices herein also assessed fraud penalty under Tax Law

§ 1145(a)(2).

2. By their petition in this matter, petitioners raised certain issues regarding the adequacy of notice of the assessments given to petitioners. In its answer, the Audit Division raised an issue as to the timeliness of the petition herein. A hearing was held on April 25, 1984 with respect to these issues and, in a decision issued on December 31, 1984, the former State Tax Commission declined to cancel the notices of determination, determined that the petition filed on behalf of petitioners was timely, and directed that a hearing on the merits of this matter be held.

3. Petitioner AAA Sign Company ("AAA Sign") was in the business of designing and manufacturing signs on a wholesale and retail basis. It maintained offices at S-3576 California Road, Orchard Park, New York. It also maintained a manufacturing plant at 162 Carrol Street, Buffalo, New York.

4. Petitioner Donn Corey was the president of AAA Sign during the period at issue. He controlled the corporation and did not dispute that he was a responsible officer thereof.

5. This matter arose as a result of Audit Division investigations and audits of certain other corporations. Donn Corey was president of such other corporations. These other audits resulted in assessments against the other corporations and Mr. Corey. Installment payment arrangements were agreed to by Mr. Corey and the Audit Division with respect to these assessments. Mr. Corey subsequently defaulted on the installment payment arrangement. No fraud penalty was imposed with respect to these prior assessments.

6. On audit in this matter, the former Special Investigations Bureau made a request of Mr. Corey for certain of AAA Sign's Federal income and State sales tax returns and corporation franchise tax reports. Said request was made on August 26, 1980 by certified mail, return receipt requested, and was addressed to Mr. Corey at AAA Sign's offices located at S-3570 California Road, Orchard Park, New York. This request was returned to the Audit Division on September 29, 1980 as "unclaimed". At the same time an identical request to the same address was made by first class U.S. mail. This request was not returned.

7. Subsequent efforts by the Audit Division to personally serve Mr. Corey with a subpoena demanding the production of AAA Sign's records were unsuccessful.

8. In October 1980, the Audit Division caused a subpoena to be delivered to the New York Secretary of State for service upon AAA Sign. In November 1980, the Audit Division served a subpoena upon a shop foreman at AAA Sign's manufacturing plant. In response to these subpoenas, Mr. Corey appeared, with counsel, at the offices of the Audit Division in Buffalo on December 9, 1980. At that time, Mr. Corey, by his counsel, invoked his privilege against self-incrimination under the Fifth Amendment and refused to answer any questions put to him by the Audit Division. He also refused to produce the corporation's records. The Audit Division did not advise Mr. Corey that criminal charges against him were not being contemplated.

9. The Audit Division made no attempt to contact Mr. Corey following the December 8, 1980 meeting.

10. The Audit Division subsequently obtained copies of the corporation's Federal returns and conducted an audit by comparison of gross sales as reported on the corporation's sales tax returns and gross sales (less sales tax included in gross sales on the returns) as reported on the corporation's Federal income tax returns. This comparison revealed the following:

<u>Period</u>	<u>Gross Sales Reported</u>		<u>Difference</u>
	<u>Federal</u>	<u>Sales Tax</u>	
6/1/75-5/31/76	\$ 83,683.64	\$ 58,816.89	\$ 24,866.75
6/1/76-5/31/77	143,449.00	35,014.55	108,434.45
6/1/77-5/31/78	257,079.00	41,558.00	215,521.00
6/1/78-5/31/79	<u>289,551.00</u>	<u>159,915.91</u>	<u>129,635.09</u>
	\$773,762.64	\$295,305.35	\$478,457.29

11. Reported taxable sales, per sales tax returns, for the four periods set forth above, amounted to 76%, 87%, 92% and 84%, respectively, of gross sales reported per sales tax returns. The Audit Division applied these percentages to the Federal income/sales tax gross sales differences set forth above to determine additional audited taxable sales for each of the sales tax periods at issue.

12. AAA Sign did not file a Federal income tax return for its fiscal year ended May 31, 1980. It did file sales tax returns for the quarters comprising that fiscal year and reported a total of \$302,485.02 in gross sales on said returns. Total taxable sales reported for the quarters comprising fiscal year ended May 31, 1980 were 92 percent of gross sales. To determine additional taxable sales for fiscal year ended May 31, 1980, the Audit Division determined the average percentage of difference between gross sales reported for sales tax purposes and gross sales reported for Federal purposes for the four-year period June 1, 1975 through May 31, 1979 (\$478,457.29 divided by \$295,305.35). This amounted to 162 percent. This percentage was then applied to reported gross sales per sales tax returns to project a "difference" between Federal and sales tax gross sales figures for fiscal year ended May 31, 1980 of \$490,025.73. The reported taxable sales ratio of 92 percent was then applied to this amount to determine additional audited taxable sales for the period June 1, 1979 through May 31, 1980.

13. The corporation filed quarterly sales tax returns for all of the periods at issue. The returns for the quarters ended August 31, 1975 through August 31, 1977 and February 28, 1978 were stamped with the signature "Jerome Joseph". The returns for the quarters ended November 30, 1977 and May 31, 1978 through August 31, 1979 were signed "Carol Beyer". Returns for the periods ended November 30, 1979 and February 29, 1980 were not produced at hearing. The return for the period ended May 31, 1980 was signed "Donn Corey".

14. "Jerome Joseph" was a name used, on occasion, by Donn Corey. Carol Beyer ran AAA Sign's business office during the period at issue.

15. AAA Sign's Federal income tax returns and State franchise tax reports were prepared by an outside certified public accountant using the corporation's general ledger which was provided to the accountant by Carol Beyer. The accountant was not involved in the preparation of the corporation's sales tax returns as such returns were prepared within the corporation. Carol Beyer was described by the corporation's outside accountant as a "one-person office" who had difficulty "keeping up" with the volume of work generated by the corporation. The accountant advised Ms. Beyer that problems could result from the manner in which sales taxes were being reported.

16. At the commencement of the hearing, the Audit Division asserted, as an alternative to the fraud penalty, the penalty for failure to file a return or pay tax imposed under Tax Law § 1145(a)(1). This alternative penalty was not asserted in either the notices of determination or the Audit Division's answer.

### CONCLUSIONS OF LAW

A. Mr. Corey's refusal to provide the Audit Division with AAA Sign's books and records allowed the Audit Division to determine the corporation's sales tax liability by using an audit method reasonably calculated to reflect tax due (see \_\_\_ Tax Law § 1138[a][1]; Matter of Grecian Square v. State Tax Commn., 119 AD2d 948). The audit method employed herein was so reasonably calculated.

B. Under the facts presented herein, petitioners bore the burden of proving by clear and convincing evidence that both the method used to arrive at the tax assessment and the assessment itself were erroneous (see \_\_\_ Matter of Sol Wahba, Inc. v. State Tax Commn., 127 AD2d 943). Petitioners have failed to sustain their burden as no evidence was presented at hearing to refute either the audit method or the audit result.

C. In 1975, the New York Legislature added the so-called "fraud penalty" to the sales tax by adding section 1145(a) (former [2]) to the Tax Law. Section 1145(a) (former [2]) provided in pertinent part:

"If the failure to file a return or to pay over any tax to the tax commission within the time required by this article is due to fraud, there shall be added to the tax a penalty of fifty percent of the amount of tax due (in lieu of the penalty provided for in subparagraph (i) of paragraph one) plus interest...." (Emphasis added.)

The Legislature modeled the fraud penalty of section 1145(a) (former [2]) on the penalty provisions already existing with respect to deficiencies of, inter alia, income tax. (See \_\_\_, 1975 NY Legis Ann, at 350.) "The burden of showing fraud under section 1145(a)(2) has been consistently interpreted to reside with the [Audit] Division." (Matter of Ilter Sener d/b/a Jimmy's Gas Station, Tax Appeals Tribunal, May 5, 1988.)

D. "The standard of proof necessary to support a finding of fraud requires 'clear, definite and unmistakable evidence of every element of fraud, including willful, knowledgeable and intentional wrongful acts or omissions constituting false representation, resulting in deliberate nonpayment or underpayment of taxes due and owing.' (See \_\_\_, Matter of Walter Shutt and Gertrude Shutt v. State Tax Commn., State Tax Commn., July 13, 1982.)" (Matter of Ilter Sener, supra.)

E. Upon review of the evidence presented, the Audit Division has failed to sustain its burden of proving that the imposition of the fraud penalty was proper. The evidence established that AAA Sign consistently underreported its taxable sales during the period at issue and that Mr. Corey was uncooperative with the Audit Division (Findings of Fact "6" and "8"). Similar facts have properly been considered to be circumstantial evidence of fraud (see \_\_\_, e.g., Gromacki v. Commr., 361 F2d 727; Miliken v. Commr., 798 F2d 830). A review of the totality of the record, however, compels a finding that the Audit Division has not established the requisite elements of knowledge and intent on the part of petitioners to sustain the fraud penalty. More to the point, and contrary to Audit Division contention, the existence of prior sales tax assessments against Mr. Corey and certain other corporations with which Mr. Corey was associated does not imply the existence of a fraudulent intent in the instant matter. Nor does such evidence establish, as the Audit Division contends, a level of sophistication on Mr. Corey's part. If anything, such evidence tends to establish a lack of sophistication and a high degree of negligence on Mr. Corey's part, but not fraud. Additionally, the record does not establish that

Mr. Corey evaded process servers. Evidence presented by the Audit Division on this point relies too heavily on conclusory, hearsay statements and this assertion by the Audit Division cannot be accepted as fact herein.

Finally, weighing against the Audit Division's fraud assertion is the evidence in the record regarding the manner in which the sales tax returns were prepared. Carol Beyer, described as the "one-person office" of AAA Sign, had difficulty keeping up with the volume of bookkeeping which the corporation generated. This fact compels an inference that the sales tax returns herein were prepared negligently, but not fraudulently.

The "nonexistence" of "Jerome Joseph" is troubling (Finding of Fact "14"). Certainly the record does not show any legitimate reason for Mr. Corey's use of this name. The record also fails to show, however, that Mr. Corey's use of "Jerome Joseph" was intended, or in fact did serve to mislead the Audit Division or to conceal taxable sales of AAA Sign.

The use of "Jerome Joseph", along with petitioners' consistent underreporting and Mr. Corey's uncooperative stance, all serve to create the suspicion of fraud. Such suspicion is not sufficient to sustain the fraud penalty (see \_\_\_ Estate of Arnold Windsberg, 37 TCM 456, 460). The totality of the evidence herein fails to establish that AAA Sign's sales tax returns during the period at issue were knowingly and intentionally filed such that an underreporting and underpayment of sales tax resulted therefrom.

F. The Audit Division may assert the penalty pursuant to Tax Law § 1145(a)(1) as an alternative to the fraud penalty in its answer, but when it does so it bears the burden of proof to show that such penalty is properly imposed (Matter of Ilter Sener, supra). When, as here, the Audit Division asserts such penalty at hearing, the primary concern is the adequacy of notice to petitioners of the penalty; viz., as a result of the Audit Division's assertion of the Tax Law § 1145(a)(1) penalty in this manner, has the petitioners' case been prejudiced in any way?

Internal Revenue Code § 6214(a) provides that the Tax Court has jurisdiction to consider a claim by the Internal Revenue Service for an increased deficiency or addition to tax at any time before the entry of a final decision.<sup>1</sup> (See \_\_\_ Ferrill v. Commr., 684 F2d 261, 265; Henningsen v. Commr., 243 F2d 954, 959; Forseth v. Commr., 50 TCM 111.) "It is the purpose of section 6214(a) to give petitioner a fair opportunity to answer and resist the claim before it is considered by the Court." (Sundstrand Corp. v. Commr., 52 TCM 958, 959.) Consequently, in the absence of evidence of surprise or substantial disadvantage to petitioner, the Tax Court may grant the Service's motion to amend its answer pursuant to Rule 41(a) of the Tax Court Rules of Practice and Procedure<sup>2</sup>, and may properly make a determination regarding the increased deficiency or addition to tax (see \_\_\_ Ferrill v. Commr., supra; Law v. Commr., 84 TC 985;

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<sup>1</sup>Inasmuch as the sales tax penalty provisions were, in essence, modeled after Federal penalty provisions (see \_\_\_ Matter of Ilter Sener, supra), Federal statutes and case law are properly used for guidance (Matter of Levin v. Gallman, 42 NY2d 32).

<sup>2</sup>Rule 41(a) of the Tax Court Rules of Practice and Procedure provides that pleadings may be amended after the case has been placed on a trial calendar and over the objection of the opposing party only by leave of the Court, and that "leave shall be given freely when justice so requires".

Forseth v. Commr., supra).

G. It is reasonable to apply the Federal standard to the instant matter. In this case, the Audit Division asserted the section 1145(a)(1) penalty at the commencement of the hearing. Petitioners did not object to the Audit Division's assertion of such penalty. In light of this fact, and that elements justifying the imposition of the two penalties do overlap in some cases (see \_\_\_, Matter of Ilter Sener, supra), the Audit Division's assertion of the section 1145(a)(1) penalty under the circumstances presented herein does not result in prejudice to petitioners. Accordingly, the issue of the section 1145(a)(1) penalty in this matter was properly asserted before the Administrative Law Judge.<sup>3</sup>

H. Having determined that the Audit Division's assertion of the section 1145(a)(1) penalty was proper, it is clear pursuant to the rule of Sener that the Audit Division bears the burden of proof with respect to this issue and must establish that "[petitioners'] failure or delay was due to willful neglect and was not due to reasonable cause" (Matter of Ilter Sener, supra).

I. The Audit Division has met its burden. The factors discussed in Conclusion of Law "E", e.g., petitioners' consistent underreporting over a five-year period; the lack of cooperation with the Audit Division; the failure to produce records; the preparation of sales tax returns internally even after having been advised by an accountant of potential sales tax problems; previous audits which should have alerted Mr. Corey to his own ineptitude regarding bookkeeping and the filing of returns; all strongly support the imposition of the section 1145(a)(1) penalty. In fact, the record is devoid of any facts to support a contrary result.

J. In light of the determination herein that the Audit Division has not met its burden with respect to the fraud penalty, the assessments herein were subject to the three-year statute of limitations under Tax Law § 1147(b). The determinative date with respect to when an assessment is made under Tax Law § 1147(b) is the date of issuance of the notice (see \_\_\_ Maplecrest Sausage Co., Inc. v. Tully, 67 AD2d 329). Although not all returns herein were timely filed, there is no evidence in the record to suggest that any of the returns for the period June 1, 1975 through August 31, 1978 were filed within three years of December 7, 1981, the

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<sup>3</sup>Additional support for this result may be found in the Tax Appeals Tribunal Rules of Practice and Procedure (20 NYCRR 3000 et seq.). Section 3000.4(c) of the Rules provides for the amendment of pleadings upon consent of the Administrative Law Judge:

"Leave [to amend pleadings] shall be freely given upon such terms as may be just, including the granting of continuances. The administrative law judge...may permit pleadings to be amended before the hearing is concluded to conform them to the evidence, upon such terms as may be just including the granting of continuances."

Applying this rule to the instant matter, the Audit Division's assertion of the section 1145(a)(1) penalty at hearing, although not formally phrased as such, constituted a motion to amend its answer. The absence of prejudice to petitioners (discussed above) results in the granting of the "motion" and the consideration herein of the section 1145(a)(1) penalty.

date of issuance of the notices of determination herein. Consequently, the assessment of tax due against petitioners with respect to the period June 1, 1975 through August 31, 1978 is time barred pursuant to Tax Law § 1147(b) and is therefore cancelled.

K. The petition of AAA Sign Company and Donn Corey, as officer, is granted to the extent indicated in Conclusions of Law "E" and "J" and is modified to the extent indicated in Conclusion of Law "I"; the Audit Division is directed to adjust the notices of determination and demands for payment of sales and use taxes due issued herein in accordance therewith; and, except as so granted, the petition is in all other respects denied.

DATED: Albany, New York  
July 21, 1988

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ADMINISTRATIVE LAW JUDGE